## Failure Test

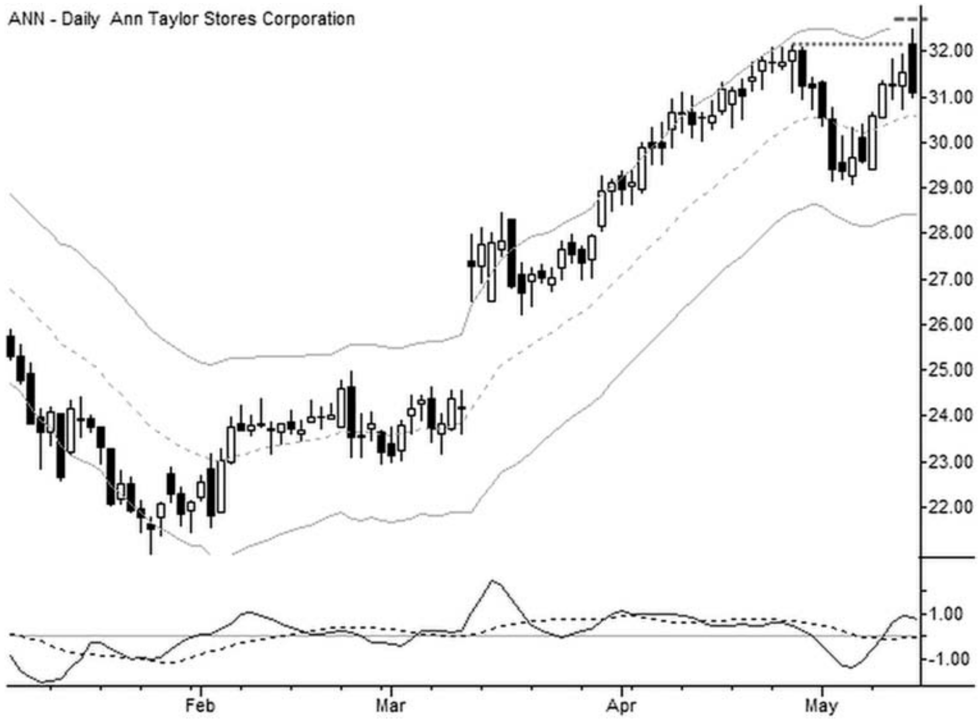


**FIGURE 10.19** A Failure Test in Ann Taylor (NYSE: ANN)

**Setup** ANN had been in a multimonth uptrend, and was, in fact, a market leader for a substantial part of the advance shown in Figure 10.19. In general, it is difficult to find spots to short market leaders, so only the best and clearest trades are appropriate. A strong sell-off going into May broke the established pattern of the trend, putting with-trend traders on notice and giving countertrend traders warning to start watching for potential entries. This is an important and often overlooked aspect of countertrend trades: you must have some reason, some justification for even considering a countertrend trade, and the best justification is price action that shows a distinct change of character.

**Entry** The actual entry was on the day that pressed to a new high and immediately reversed, closing strongly lower. There is a trade-off between trade location and confirmation here. While an astute intraday trader may have been able to position somewhere near the high of the day, a trader doing so as a matter of course will unavoidably have many losing trades that reverse and take out the highs. A trader waiting for the close will give up significant price movement in return for the confirmation. Either plan will work if it is applied with discipline.

**Stop** The stop in this trade should be located at or around (within a few pennies of) the previous trend high. Many traders will place the stop *outside* the previous trend extreme, but this can result in considerable slippage. Placing the stop inside the previous extreme will result in a rare stop-out where the trade is still valid, but the reduced slippage on nearly all exits will more than compensate.

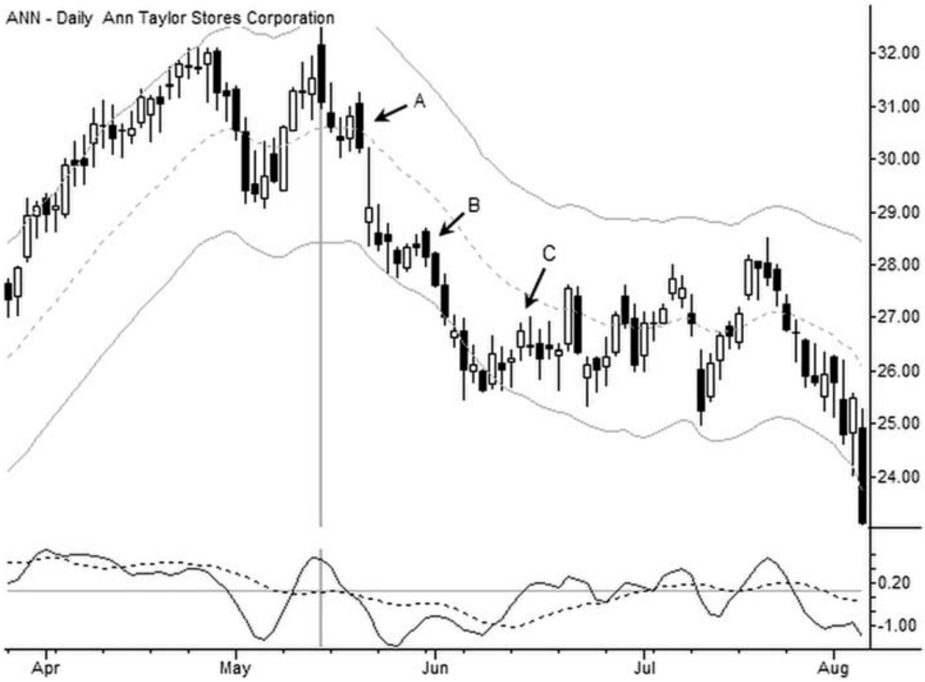


**FIGURE 10.20** A Best-Case Failure Test Outcome

The chart in Figure 10.20 is an example of practically the best possible outcome from a trade like this. First (1×) profit targets would have been hit early on, and in this case, the failure test actually marked the extreme high point of the trend.

A: After a strong downthrust, a small consolidation like this often points to more downside—you can enter new positions here, add to existing positions, or just use the pattern as a reference to manage existing exposure.

B: Even if you do not choose to trade pullbacks, they are the fundamental structure of trends, and being able to read price action around pullbacks will give you great insight into the integrity of the trend. Many traders would have covered much of their trade by this point, but seeing small consolidations break down cleanly could give you justification for holding part of the trade.

C: Continuing with that theme, when you see these patterns *not* break down as cleanly or easily, it is a sign that something has shifted and the easy money in the trade is probably over.

**Conclusions** This is admittedly a best-case example of a clean and simple failure test trade. It is absolutely essential to maintain the discipline of taking partial profits at the 1× target, because many of these trades will quickly reverse and continue the original trend. In addition, it probably makes sense to do these failure test trades on smaller risk for two reasons: stops tend to be very tight, often less than a single day's range, and there is increased danger of catastrophic gap failure through the old trend extreme.

## Failure Test, Second-Day Entry

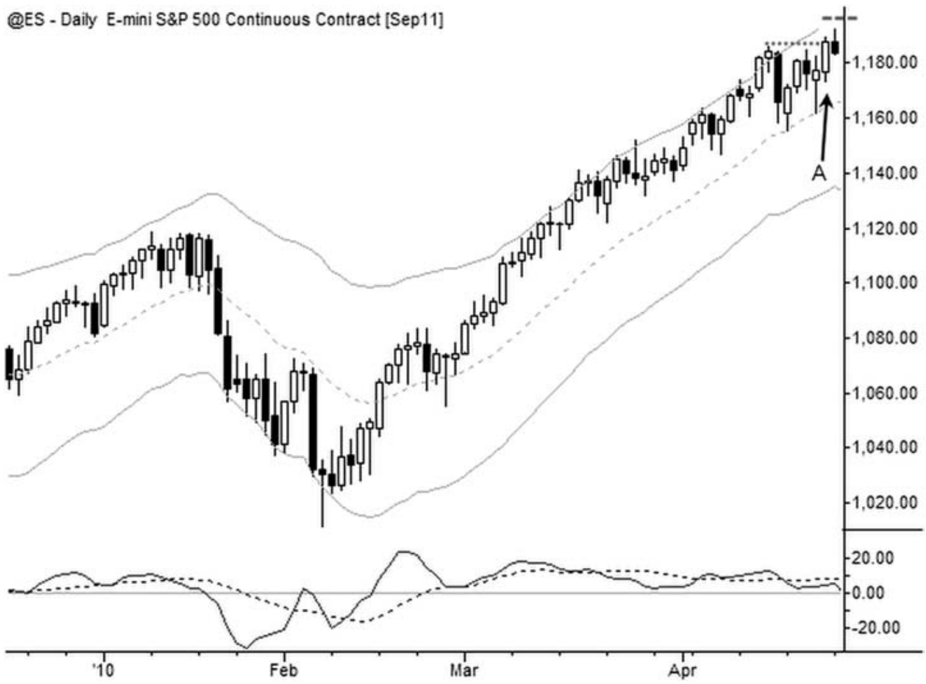


**FIGURE 10.21** A Second-Day Failure Test Entry

**Setup** The S&P 500 index, shown in Figure 10.21, had been in a yearlong uptrend and was showing signs of possible overextension on higher time frames. There was no strong down move setting up this countertrend trade, but there were multiple momentum divergences and failures on lower time frames that set up the possibility of a successful fade trade.

### Entry

A: The actual entry is slightly more complex in this case. This bar presses to new highs and closes slightly above the previous resistance level. The next day trades high, then reverses to close under the old highs. Entry is on the close of the last bar on this chart.

**Stop** The stop should be around the small, downward-closing candle's high, which is slightly less than an average day's range from the entry. It is appropriate to risk less on these trades; having a very large position size (required by the tight stop) near the high of a strong market in a strong trend is potentially dangerous.

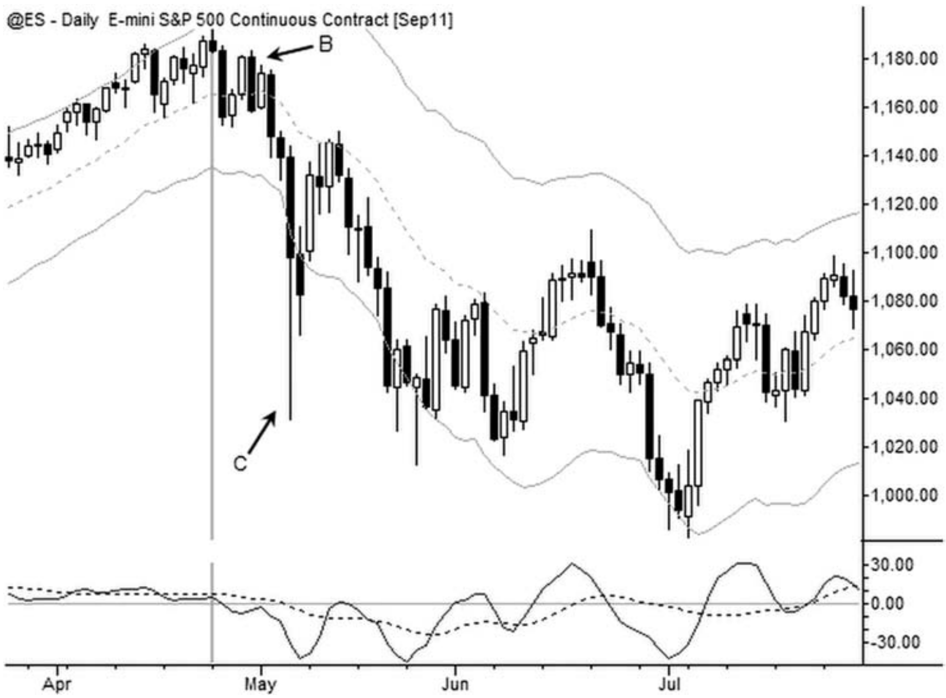


**FIGURE 10.22** First Profit Target Is Quickly Hit

The next day (Figure 10.22) saw strong selling, and the 1× profit target was exceeded on this day. Again, even though the market may be very weak, maintain the discipline of these partial exits—this is absolutely crucial to your long-term success with these trades.

B: The same concept at work as in the previous example: a brief consolidation breaks down into another down move. This is justification for continuing to hold part of the position.

C: This is the May 2010 Flash Crash. If you are ever holding a position into such an exceptional move, cover part or all of the position into the move. Do not be greedy and do not play for a one-in-a-million event. On those very rare occasions when the market offers windfall profits, take them.

**Conclusions** This is another exceptional outcome for a failure test trade, but does illustrate the power of this very simple trade entry. Traders who blindly fade trends will suffer loss after loss, while traders working with disciplined technical patterns like this can fade trends safely and effectively. There is also a lesson here in the interaction of

intuition with disciplined technical rules. I had been writing in my daily research report that the market was overextended and that there was a dangerous degree of complacency. On the day of this entry, I wrote that the market was "vulnerable so that when a shock finally does hit . . . the effect may be out of all reasonable proportion."

This is not to say that this pattern predicted the Flash Crash. Far from it, for that was a completely unforeseeable outlier event, but the fragility of the market was apparent from an intuitive perspective, and this pattern provided a safe entry near the absolute high of the trend. We never know what opportunity a trade might offer—the best we can do is to enter on clear patterns, take partial profits, and manage the risk.

## Failure Test, Other Variations

The failure test pattern itself is very simple, with only two significant variations: entry on the bar that makes a new trend extreme or on the following bar. The entry is probably best made on the close of one of those bars, but some traders will find success timing intrabar entries with a few potential trade-offs. (Note that both previous examples were shorts, but the trade is perfectly symmetrical for the buy setup.) There are a few common variations of patterns that set up this trade; the entry is consistent in all cases, the only difference being the preceding market structure.

**Following a Long Consolidation** Many times a market will show a series of consistent consolidations (say five to eight bars), and then will consolidate near the trend extreme in a much longer consolidation, perhaps three or four times the normal length. Many traders would regard such a pattern as a sign of real with-trend pressure, but it often sets up a good countertrend trade on a failure test. Be on guard for failure out of these long consolidations. It is also worth considering what separates this pattern from a long prebreakout base. Though some of these long flags will function as a prebreakout base, the main difference is location in the trend. Consolidations tend to be near the trend extreme in a long trend, whereas breakout bases come after protracted trading ranges and usually not near an identifiable trend extreme.

**Following a Climax** There are a number of patterns that point to a potentially climactic trend ending: three pushes, parabolic expansion, or multiple free bars. As always, it is usually counterproductive to try to get in front of these patterns and establish early countertrend positions in what could simply prove to be a very strong trend. It is better to wait for the potentially climactic structure, the first reversal off that structure, and then be on guard for a failure test at the previous extreme. This is a disciplined and relatively safe way to trade an aggressive countertrend trade.

**As Entry into Higher Time Frame Structure** Some of the best trades come where failure tests market precise entries into higher time frame patterns. For instance, if the weekly chart is setting up bullish continuation patterns, failure tests of lows on the daily or hourly chart can provide outstanding entries.

## FAILURE TEST FAILURES

On one hand, failures of the failure test pattern are simple—the market makes a new extreme and keeps going. However, this understates the potential damage and risk around these points. Some of these trades may fail with large gap moves, forcing the trader to exit far beyond the intended risk point. There is no perfect solution that can avoid all of these cases, but in addition to perhaps trading these with smaller risk, being aware of the patterns that typically set up failure of these patterns can provide additional insight into developing market structure.

### Failure Test Failure by Consolidation


**FIGURE 10.23** A Failure Test Fails by Consolidation

A: This was an example of a slightly more complex entry on the *third* bar following a market high in Figure 10.23. This is an acceptable variation, particularly in the low-volume, preholiday environment of late December, but it is not a model entry.

B: This move falls short of the first profit target, which is a warning sign. In most cases, the stop and the first profit target on failure test trades are both relatively close to the entry price. You should not have to wait more than three or four bars for the profit target to be hit, and many times it will be reached on the first bar following the entry. It is justifiable to reduce risk in the trade (by exiting part of the position) somewhere following B because the trade is not working as well or as cleanly as expected.

C: Exactly how long you hold the trade is a personal decision, but somewhere following C holding becomes a matter of hoping rather than of positioning with a clean, working trade. In this example, the worst outcome should have been scratching the trade, exiting very near the entry price for a small gain or loss.

### Failure Test Failure by Consolidation

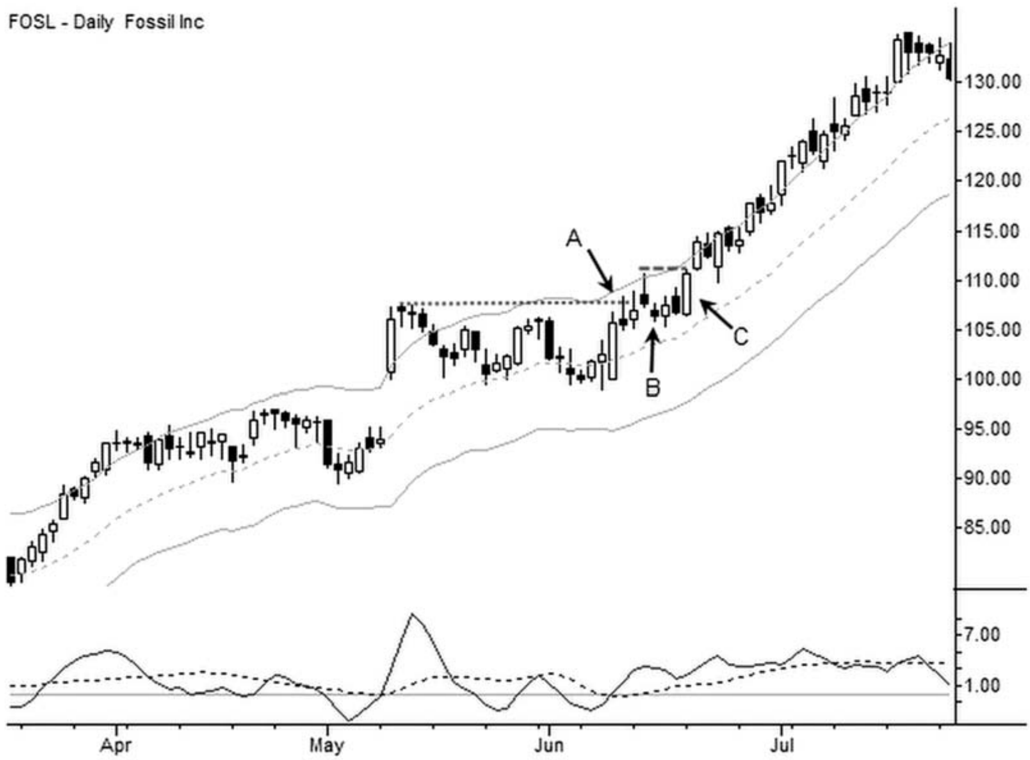


**FIGURE 10.24** Another Example of Failure by Consolidation

A: The chart in Figure 10.24 shows also another nonstandard entry, but the less-than-perfect outcomes of these trades are probably not due to the quality of the setup patterns. Fossil Inc. (Nasdaq: FOSL) was a fairly illiquid momentum stock during

this time period, so it did not trade cleanly around levels. An entry could have been attempted at A, but most traders would have wanted to see more decisive action above resistance to set up an entry.

B: The best entry for this trade is probably at B, but it may also have been a second entry for traders who booked a loss following A. Consider expectations for a trade like this, particularly in a market-leading momentum stock: If the trade is correct, the stock should immediately melt. There should be sharp and clean downward momentum away from the level.

C: This downward momentum did not develop, and the trade eventually failed at C. In this case, the preceding consolidation was small, only two or three bars. It is a challenge to make adjustments to the trade within this time period, so it is reasonable to expect that a trader might have booked another loss at C. This is another reason for doing these trades on half risk, relative to most other trade classes. In this example, a trader might have taken full losses following two entries at both A and B. Though unusual, this does happen, so it must be anticipated in the trading and risk management plans.

## Failure Test Failure with Second Entry


**FIGURE 10.25** A Failure Test with Obligatory Second Entry

A: A simple, classic failure test entry in Figure 10.25, which also corresponds with a pullback failure via failure test. Assume that the entry was on the close of this bar so that the first target was not hit on the next bar.

B: The high of B slightly exceeds the high of A, so realistically, the short should have been stopped out. In this case, reentering on the close of B allows an excellent entry into a second trade that more than makes up for the loss on the first trade. Some traders look at trades like this and reason that they should not stop out of the first trade. This is a mistake—too many of these trades fail with dramatic moves beyond the high of A, so your focus must be on limiting risk and correctly exiting the losing trades.

C: Again, the small consolidation breaks down, confirming the health of the downtrend. When the ensuing thrust runs out of steam near the previous pivot low, it probably makes sense to close the trade and look for clearer opportunities.

There is an important lesson here. Though the first trade failed, the second entry is almost required. If you have let the first loss get out of control through inappropriate position size or poor stop discipline, it is very difficult to justify taking a second swing at the trade. Maintaining iron discipline *on every trade* is perhaps the most important part of building trading consistency.

## Failure Test, Other Failures

There are a number of other possible failures for this pattern, but two deserve special attention. It is not uncommon to see these patterns fail at or near the first target. These targets may be touched overnight or in premarket, so it is important to have profit-taking orders working all the time, good until canceled and outside of regular trading hours. Sometimes other players make mistakes in those thin markets outside regular trading hours; it is your job to be ready to take advantage of those mistakes with well-placed profit-taking orders. One of the keys to trading these patterns well is to be very disciplined in taking profits at this first target. It is unacceptable to have a trade trade through the first target and then turn around and hit the stop, and for you to have taken a full-sized loss on the trade with no profits booked. This is not even technically a *failed* pattern because it did hit the first target, so follow the rules and manage trades appropriately.

The second failure to consider is the possibility of a failure by a large adverse gap. Though not common, you are positioning countertrend near the trend extreme with this trade setup, so a trend-continuation gap can be a dangerous event. Gaps in the direction of the trade (i.e., through the first target) are more common, but plan for the possibility of a larger-than-expected loss on some set of these trades. Trading these failure tests on smaller size, perhaps half the size of normal, with-trend trades, is a prudent risk management step.

## TRADING PARABOLIC CLIMAXES

Parabolic climaxes are disorderly, volatile areas. It is difficult to initiate positions in these conditions, either with or against the predominant trend, but they also present challenges for traders managing existing positions. The two biggest challenges are first, to recognize that a market is parabolic, and second, to stand apart from the emotional reactions of the crowd. In both cases, a rigid technical discipline is the answer.

### Trading Parabolic Climaxes: Stand-Alone Entries

In general, trade entries within parabolic climaxes are problematic. It is usually impossible to find the precise turning point; wide spreads, low liquidity, and rapid price movement work against a trading plan that attempts multiple entries. However, these areas do give important information about the trend, and offer some attractive opportunities for countertrend trading. Two of the best plans use the parabolic climax as a setup for other countertrend entries.

**Failure Test Entry** Prices sometimes collapse after a parabolic entry, but it is also possible that the trend will continue following a more extended consolidation. Many players are focusing on this possibility; prices are already at dramatically extended levels and many traders are thinking only about catching the next big move. Furthermore, many of them will use a break to new highs (or lows in a downtrend) as an entry point. If they are wrong, there can be mass panic as they scramble to adjust losing positions in a market that rapidly snaps back.

This sets up an ideal opportunity for a failure test. Rather than dealing with the uncertainty and poorly defined risk limits in the actual climax, astute traders can wait for a failure test on a retest of the trend extreme. Of course, some of these trades will be failures—these are the set of failure test failures that tend to have exceptional slippage compared to normal failure tests. It is also important to manage trades appropriately; failure test entries following climactic moves should see immediate and sharp countertrend movement, driven by trapped trend traders. If this move does not develop, the probabilities start to tilt back in favor of consolidation and continuation.

**Setup for Anti** A parabolic climax can also set up an Anti trade. In this case, it is important to look for an initial sharp countertrend move that shows a distinct change of character. Position sizes may be smaller due to elevated volatility, but this can be a very attractive entry into the reversal following a parabolic expansion.

### Trading Parabolic Climaxes: Managing Existing Positions

The example shown in Figure 10.26 is different from the others in this chapter. I am reproducing (edited) comments from my daily market report that show the evolution of my thought process and the risk management plan at different points in the move. Once Silver went fully parabolic, my plan was to basically stop out under the previous day's

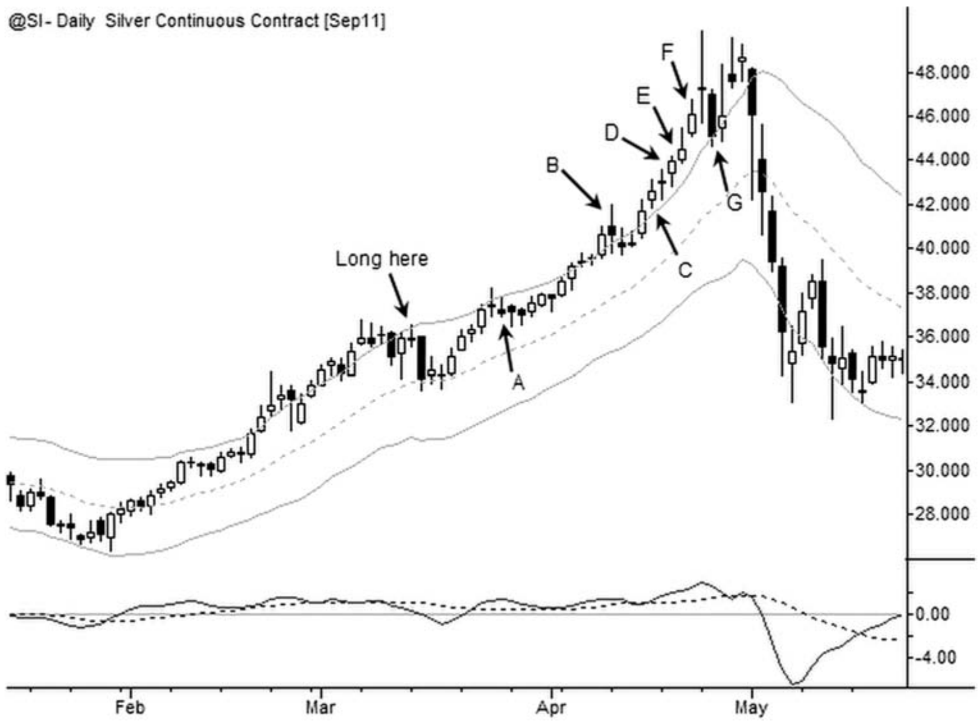


**FIGURE 10.26** A Developing Climax in Silver Futures

low—a very tight stop in a volatile market, but also a reasonable risk point. In this case, the exit was fortuitous, coming on the day following the ultimate high for the move; not all trades will have outcomes this dramatic, but you must respect the potential for a very dangerous countertrend move when the climax finally turns.

A: "I have been . . . able to tighten the stop to above the entry price. I am still deeply distrustful of the trend . . ., but, for now, am positioned to take advantage of any continued upside." *This is a case of using a high and tight pullback to tighten the stop on an existing trade. Though no contracts were added in this pattern, a failure of the pattern would have been very bad for the trade, so a tighter stop was justified. Consider also that, even though I was uncomfortable with the potential in the trade, I did not exit and so was positioned to profit from the ensuing uptrend.*

B: "Silver is certainly overbought by any measure, but this is not a case where fading strength is justified." *Taken alone, the concepts of overbought and oversold are dangerous and are probably overemphasized in much of the literature. Strong trends reach overextended levels and just keep going.*

C: "My aggressive addition to Silver worked . . . stop [is now] just under yesterday's low." *The two small days provided another entry point to add additional exposure—yet another variation of the high and tight consolidation.*

D: "I have moved the stop to just below yesterday's low. In the intermediate term, everything suggests higher prices, and the possibility of extreme volatility. The challenge is . . . balancing profit taking . . . [against] holding a core position."

E: "The break, when it does come, could be dramatic. . . . I am working a tight stop very close to yesterday's low."

F: "I am ratcheting the stop very tightly every day. This is a profit-taking strategy, looking for weakness to take us out of the market." *Trade management does not always mean executing. In this case, tightening the stop reduced risk and locked in additional profits on a daily basis. Even though there were no executions, this is active trade management.*

G: "We were taken out of our long position in Silver futures yesterday, having booked a good profit for five weeks' work," *and the market immediately collapsed into a dramatic sell-off. Not all trades will be this dramatic, but rather than extrapolating the move and seeing virtually unlimited profits, always consider the possibility of a collapse like this. In this case, a simple technical pattern and a very tight trailing loss allowed our clients to sell Silver the day following the high water mark for the uptrend.*

## Climax Failures

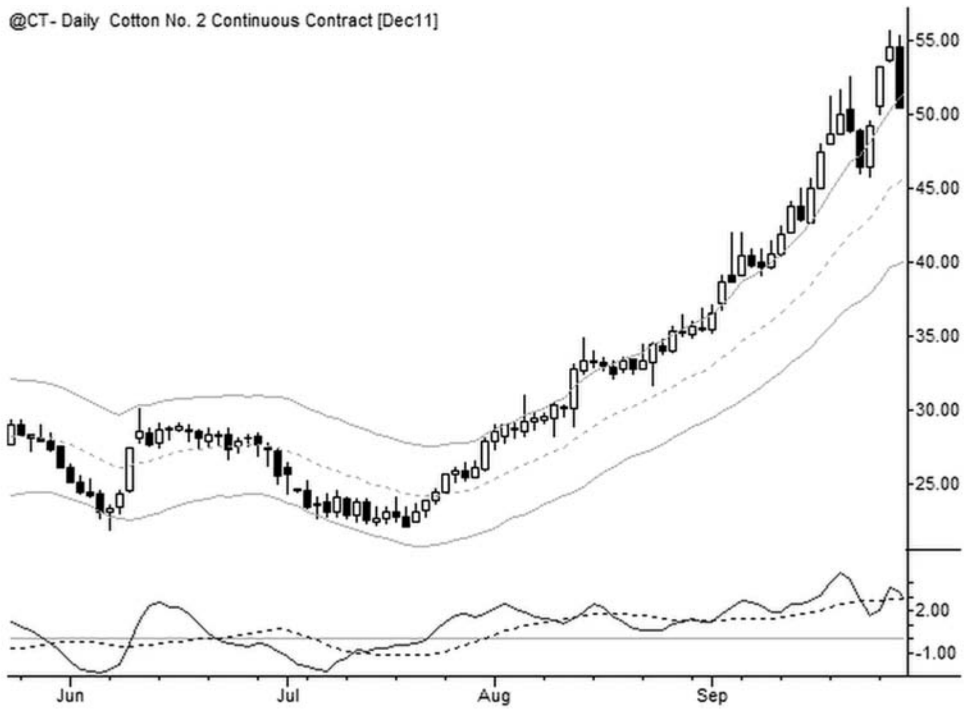


**FIGURE 10.27** Does This Climax in Cotton Set Up a Short Trade?

The chart in Figure 10.27 has all of the signs of a classic buying climax: it is in a mature trend, the trend has accelerated into steeper trend legs, there have been multiple thrusts above the Keltner channels, the MACD shows a glaring momentum divergence, there are numerous free bars above the upper channel, and the last bar suggests a breakdown may have begun. In fact, the last bar on this chart is a standard failure test entry of the highs following a climax. Is this a good entry?

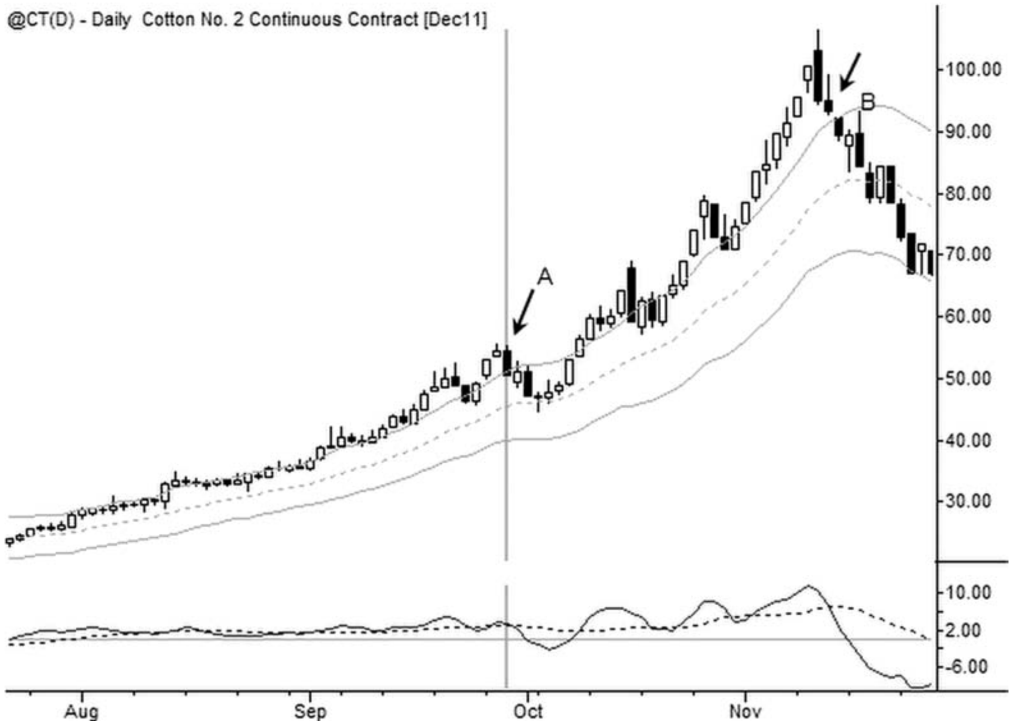


**FIGURE 10.28** A Parabolic Climax Can Extend Much Further Than Anyone Would Expect

A failure test entry at the point of A in Figure 10.28 would have failed after reaching the first target. With proper trade management, this trade would have been a scratch or a small profit. However, the point here is that countertrend trades initiated in climax patterns are subject to failure, and when they do fail, they will do so through trend continuation. In this case, after further consolidation, the trend continued, accelerating even more dramatically.

Note that there was no other entry on this chart, not even at the ultimate collapse at B. Many traders will look at a chart like this and try to find some way they could have entered a trade. This is a mistake. Your job as a trader is simply to trade well-researched patterns that are in alignment with the underlying tendencies of the market. There are many large moves in the market that do not offer an attractive entry point. This is one of them.